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Planning Under Generation Skipping Tax

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PLANNING UNDER THE GENERATION-SKIPPING TAX

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> Your Committee recognizes that there are many legitimate nontax purposes for establishing trusts. However, it also believes that the tax laws should be neutral and that there should be no tax advantage in setting up trusts. Consequently, the Committee bill provides generally that property passing from one generation to successive generations in trust form is to be treated, for estate tax purposes, substantially the same as property which is transferred outright from one generation to a successive generation. Your Committee's bill does provide one limited exception to this general rule, however, to cover the case where a trust is established for the benefit of the grantor's grandchildren.[1]

The Tax Reform Act of 1976[2] frequently has been referred to as the most sweeping tax measure passed by Congress since the Internal Revenue Code of 1954.[3] Although the Act is primarily amendatory insofar as it affects federal gift and estate taxes, it creates a new transfer tax that complements the previously existing tax structure. This new tax is entitled *Tax on Certain Generation-Skipping Transfers* and is found in chapter 13 of the Code under subtitle B—Estate and Gift Taxes.[4] The generation-skipping tax is not the most significant change under the Act, and, although it may somewhat change estate planning and trust administration, the new transfer tax will not necessarily increase the overall tax burden incurred by a family which receives successive transfers.

The new provisions of chapter 13 are extremely complicated and contain many overlapping and inter-dependent definitions. A close analysis of these, as well as the exemption for trusts for the benefit of grantors' grandchildren, however, leads to the conclusion that the tax will not apply in many cases and that, even where it does, it can be minimized or even avoided altogether.

This article will share some initial thoughts developed with such minimization in mind. After discussion describing the provisions of the new generation-skipping tax, the article will consider the law's practical effect on a hypothetical estate plan. Suggestions will be offered for drafting revisions to take advantage of the law's several exemptions. By spotlighting these estate planning opportunities, it is hoped that the practitioner will be better prepared to accommodate a client's desire to transfer wealth with minimal tax consequences.[5]

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[1] H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 47 (1976) *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3401 [hereinafter H. REP.].

[2] Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[3] 26 U.S.C. §§ 1 *et seq.* (1970).

[4] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520 (adding new §§ 2601-2622 to the Code).

[5] For an additional comprehensive review and analysis of the generation-skipping tax, see R. COVEY, GENERATION-SKIPPING TRANSFERS IN TRUST (1976) [hereinafter COVEY]; Bloom,

I. GENERAL SUMMARY—GENERATION-SKIPPING TAX PROVISIONS

As most estate planners are well aware, under prior law, subject to the applicable Rule Against Perpetuities, an individual could leave property in trust for the benefit of his spouse for life, then for his children for life, then for his grandchildren for life, with the final termination distribution to his great-grandchildren. Although the donor of such a trust would be subject to either gift tax or estate tax at the creation of the trust on the portion of the trust property not qualifying for the marital deduction,[6] the property held for the benefit of his children and grandchildren would escape the estate tax at their respective deaths. Only on the disposition of the property by the great-grandchildren, either by inter vivos gift or at death, would the transfer tax be imposed. Thus, the time between original transfer and final payment of transfer tax conceivably could span four generations, and take as long as one hundred to one hundred fifty years. Furthermore, the provisions of such generation-skipping trusts or trust equivalents[7] traditionally were drafted to be extremely flexible and to provide beneficiaries with all but absolute ownership of the trust property.[8] Thus, a donor was able to put property beyond the reach of the estate and gift taxes while insuring the beneficiaries' full use and benefit of the property.

The stated purpose of the new generation-skipping tax is to prevent this method of transferring wealth.[9] Congress added sections 2601-2622 to the Code in an attempt to assure that property passing in trust from one generation to successive generations will be treated, for estate tax purposes, substantially the same as property transferred outright from one generation to a successive generation. Since Congress recognized the practical nontax advantages which may be derived by using a generation-skipping trust device in an estate plan, the statute was drafted so that the new transfer tax will not cause a greater tax burden to be imposed than if no trust were used at all. In addition, a limited exclusion applies to certain trusts for the benefit of grandchildren of the donor, and by its own terms, the tax does not apply to outright transfers of wealth which cross generations. The intended effect of the statute is to shorten the period during which trust property may be kept outside of the transfer tax base to a period not ex-

The Generation-Skipping Loophole: Narrowed, but Not Closed, by the Tax Reform Act of 1976, 53 WASH. L. REV. 31 (1977); Clay, *Planning Generation-Skipping Transfers*, 116 TR. & EST. 12 (1977). (1977).

[6] *See* I.R.C. § 2056 (marital deduction). For a discussion of the 1976 Act's effect on marital deductions, see in this issue, Piper and Fremont-Smith, *Principles for Effective Use of Marital Deductions*, p. 403, *supra*.

[7] "Trust equivalents" include life estates, estates for years, insurance or annuity options, or other interest-splitting arrangements. These are all included within the definition of generation-skipping trusts under the Act. I.R.C. § 2611(d).

[8] *See* Casner, *Estate and Gift Tax Changes–Effect of Possible Revisions on Drafting of Wills*, 103 TR. & EST. 932 (1964).

[9] H. REP., *supra* note 1, at 46, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3400. The purpose of the federal estate and gift taxes is not only to raise revenue, but also to do so in a manner which has, as nearly as possible, a uniform effect, generation by generation. These policies of revenue raising and equal treatment are best served where the transfer taxes (estate and gift) are imposed, on the average, at reasonably uniform intervals. These policies are frustrated where the imposition of transfer taxes is deferred for very long intervals, as is possible, under present law, through the use of generation-skipping trusts.

ceeding the lives of the donor's children. Thereafter, the trust property will be taxed at a rate to be determined by the other property being transferred by the children and then the grandchildren from whom the property otherwise would have passed had it been left in a succession of outright transfers.[10]

A. *Basic Concepts*

Indispensable to a proper understanding of the generation-skipping tax are four basic concepts: the generation-skipping trust, the beneficiary of a generation-skipping trust, the deemed transferor of the property, and the generation-skipping transfer. Each of these concepts is derived from a confusing and complicated series of terms, not all of which are defined by the statute. The first two concepts establish the definitional framework within which the statute applies; the latter two, the mechanism by which generation-skipping transfers are made taxable.

A generation-skipping trust is one that has beneficiaries belonging to two or more generations below the grantor's generation.[11] For example, a trust for the grantor's child for life, then for a grandchild for life, remainder to a great-grandchild, is a classic form of generation-skipping trust. However, a trust for the grantor's spouse for life, with the remainder to pass outright to a grandchild, is not a generation-skipping trust, because there are not two generations of beneficiaries below, or younger than, the grantor's generation.

A beneficiary of a generation-skipping trust is an individual having a present or future interest or power under the trust.[12] An interest includes the right to receive income or principal on termination.[13] It also includes the possibility of receiving income or principal through the exercise of a power either by the beneficiary himself or another person. Under the terms of the new law, the holder of several defined powers is considered to be a beneficiary, even though such powers are held only in a fiduciary capacity.[14]

The deemed transferor of a generation-skipping trust is treated as the equivalent of the transferor of an outright transfer.[15] The amount of tax on a taxable termination or distribution from a generation-skipping trust is determined with reference to the deemed transferor, even though he is not the one liable for the tax. Usually, the deemed transferor will be the parent of the transferee most closely related to the grantor of the trust.[16] For example, if the trust is for a grandchild for life, with the remainder to a great-grandchild, the grandchild is the deemed transferor when the remainder falls in. Special definitions apply if the parent of the recipient of the trust property is not a younger generation beneficiary.[17]

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[10] *Id.*
[11] I.R.C. § 2611(b).
[12] I.R.C. § 2613(c)(3).
[13] I.R.C. § 2613(d)(1).
[14] I.R.C. § 2613(d)(2).
[15] *See* I.R.C. § 2602(a).
[16] *See* I.R.C. § 2612.
[17] I.R.C. § 2612(a)(2).

The generation-skipping transfer is the event that triggers the tax if one is to be imposed. A generation-skipping transfer can consist of either a "taxable termination" or a "taxable distribution."[18] If, for example, a trust is held for a child for life, then for a grandchild for life, remainder to the grandchild's issue, at the deaths of the child and the grandchild there will be taxable terminations. A distribution of principal made to the grandchild during the term of the trust would be a taxable distribution. A distribution of principal to the child, however, would not be a taxable distribution because it would not "skip" a generation.

B. *Statutory Definitions*

In order to fill out the above general skeleton of concepts, the Code attempts to define the most significant terms. Since the generation-skipping tax under chapter 13 is a novel system of taxation, it is important that the statutory definitions be well-understood before considering the tax implications for any given estate.

1. Generation-Skipping Transfer

A generation-skipping transfer is defined as any taxable distribution or taxable termination with respect to a generation-skipping trust or trust equivalent.[19]

2. Generation-Skipping Trust

A generation-skipping trust is any trust having younger generation beneficiaries—younger than the grantor's generation[20]—who are assigned to more than one generation,[21] for example, children and grandchildren, or children and great-grandchildren.

3. Generation-Skipping Trust Equivalent

Any arrangement which is not a trust but which has substantially the same effect as a generation-skipping trust constitutes a generation-skipping trust equivalent.[22]

4. Ascertainment (or Assignment) of Generation

Section 2611(c) provides three fundamental rules for determining in which generation a person falls: one rule applies to lineal descendants of the grantor's grandparents, a second to relationships by marriage, and a third to other relationships. Lineal descendants of a grandparent of the grantor are assigned, as would be expected, along family lines.[23] Thus, a

[18] I.R.C. § 2611(a).
[19] *Id.*
[20] I.R.C. § 2613(c)(1).
[21] I.R.C. § 2611(b).
[22] I.R.C. § 2611(a); see note 7 *supra*.
[23] I.R.C. § 2611(c)(1).

child, a nephew or a niece would be in the first younger generation; a grandchild, grandnephew or grandniece would be in the second, and so on.

The spouse of a lineal descendant of a grandparent of the grantor is assigned to such descendant's generation, and the grantor's spouse is assigned to the grantor's generation.[24] A relationship by the half blood or by legal adoption is treated as a relationship by the whole blood.[25]

An individual who is not a lineal descendant of one of the grantor's grandparents or a spouse of any such descendant, and who is not more than twelve and one half years younger than the grantor, is assigned to the grantor's generation.[26] An unrelated individual more than twelve and one half years younger but not more than thirty-seven and one half years younger than the grantor is assigned to the first generation younger than the grantor.[27] Thereafter, generation assignments drop one level at twenty-five year intervals.[28] If an individual would be assigned to more than one generation, the assignment is to be the youngest such generation.[29] An individual with an indirect interest or power in a trust through an estate, trust, partnership, corporation or other entity, with certain exceptions, is treated as a beneficiary and is assigned to a generation under the above rules.[30]

5. Younger Generation Beneficiary

Any beneficiary who is assigned to a generation younger than the grantor's generation is considered a younger generation beneficiary.[31]

6. Beneficiary

A beneficiary is any person who has a present or future interest or power.[32]

7. Interest

An interest is defined as any right or eligibility to receive income or principal.[33]

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[24] I.R.C. § 2611(c)(2).

[25] I.R.C. §§ 2611(c)(3) and (4).

[26] I.R.C. § 2611(c)(5)(A).

[27] I.R.C. § 2611(c)(5)(B).

[28] I.R.C. § 2611(c)(5)(C).

[29] I.R.C. § 2611(c)(6).

[30] I.R.C. § 2611(c)(7). The exceptions cover individuals having an indirect interest or power in certain charitable or non-profit organizations described in § 511.

[31] I.R.C. § 2613(c)(1).

[32] I.R.C. § 2613(c)(3).

[33] I.R.C. § 2613(d)(1). It would appear that any person who could be benefited by the exercise of a presently-exercisable power, whether the power is to distribute trust property in accordance with a defined standard, to appoint or to amend the trust provisions to add beneficiaries, would be considered to have an interest under § 2613(d)(1). No specific statutory provision confirms this interpretation, but the regulations should clarify the problem.

8. Power

For generation-skipping tax purposes, a power is any power to establish or alter beneficial enjoyment of income or principal.[34] With the exception of limited powers to appoint among lineal descendants of the grantor,[35] a person has a power if he has any power to affect the beneficial enjoyment of income or corpus, even if limited to a designated class or by an ascertainable standard.[36]

9. Grantor

Although the Code fails to define this term, a grantor logically can be considered to be an individual who has contributed property to a generation-skipping trust, but only to the extent of such contribution.[37]

10. Transferee

A transferee is also not defined in the Code,[38] but presumably is any individual receiving trust property as a result of a taxable distribution or a taxable termination.

11. Deemed Transferor

The parent of the transferee of the property who is more closely related to the grantor than the other parent or, if neither parent is related to

[34] I.R.C. § 2613(d)(2).

[35] I.R.C. § 2613(e).

[36] One thus may possess a power as defined in the Act even though it may not be exercised for his own benefit. Accordingly, an individual trustee could be deemed to be a beneficiary, and his death or resignation could be a taxable event. The Technical Amendments Bill to the 1976 Tax Reform Act, H.R. 6715, 95th Cong., 1st Sess. (1977), would cure this problem, however, by providing that so-called "independent" trustees would not be deemed to be holders of powers for chapter 13 purposes. An "independent" trustee would be one who has no interest in the trust, is not a "related or subordinate trustee," and has no present or future power in the trust other than to dispose of income or principal. A "related or subordinate trustee" would be one who is the spouse, parent, lineal descendent or sibling of the grantor or any beneficiary, or an employee of a corporation in which the grantor, trust and beneficiaries have significant voting control or in which the grantor or any beneficiary is an executive. *See* I.R.C. § 672(c) (relating to the income tax treatment of trusts for a comparable definition).

[37] It is hoped that the regulations will define the term "grantor". One problem that must be dealt with is the application of the generation-skipping tax to transfers of property contributed by more than one grantor; another is the determination of the grantor after a taxable termination. These problems relate most importantly to the application of §§ 2611(a)(4)(A) & (b)(5)(A) ($250,000 grandchild exclusion), § 2611(c) (ascertainment of generation) and § 2613(e) (exception to definition of power). The regulations also should provide guidance in situations involving the exceptions provided in §§ 2613(a)(4)(B) & (b)(5)(B), which exclude distributions and terminations from the generation-skipping tax base when the property transferred is subject to the gift or estate tax. Presumably the "transferor" for gift or estate tax purposes would become the grantor of generation-skipping trusts created (or supplemented) by the exercise or failure to exercise a general power of appointment.

[38] There is no comprehensive definition of "transferee" in chapter 13, although there is a provision which attempts to clarify the identity of a transferee "where it is not clear." I.R.C. § 2613(b)(3). If property is distributed outright, the result is clear. Where a trust continues, however, with interests that are subject to discretionary powers of the trustee, regulations will be required to determine when a beneficiary is "nominal" and should be ignored, and to allocate the interests among the remaining beneficiaries.

the grantor, the parent having a closer affinity to the grantor, as a general rule will be the deemed transferor.[39] If such a parent is not a younger generation beneficiary, but one or more ancestors of the transferee is a younger generation beneficiary related to the grantor by blood or adoption, then the deemed transferor is the youngest of such ancestors.[40] It is important to note that the deemed transferor need not be a beneficiary of the trust, and that a relationship by blood or adoption is considered closer than a relationship by marriage.[41]

12. Taxable Distribution

A taxable distribution is any distribution not out of accounting income to a beneficiary assigned to a generation younger than that of any other younger generation beneficiary.[42] For these purposes, an individual who at no time has had anything other than a future interest or future power is not considered as a younger generation beneficiary.[43] If, during any one taxable year, distributions of accounting income and principal are made, the distributions of accounting income shall be deemed to have been made to the beneficiaries to the extent of the total distributions made to each such beneficiary in descending order of generations, beginning with the oldest.[44] Thus, if during the year there are distributions of both income and corpus, the income portion is treated as distributed first to the older generation beneficiaries, thereby increasing the likelihood that the younger generation beneficiaries will receive a taxable distribution of corpus. Further, if any part of the tax on a taxable distribution is paid from the trust property, such part is treated as an additional taxable distribution.[45]

13. Taxable Termination

The termination by death, lapse of time, exercise, nonexercise, or otherwise of an interest or power held by any younger generation beneficiary assigned to a generation older than that of any other younger generation beneficiary also triggers imposition of the generation-skipping tax.[46] Termination of a future interest or future power is specifically not included in the definition of a taxable termination.[47] There are four special rules which permit the postponement of the generation-skipping tax on what otherwise would be taxable terminations until the termination of all

[39] I.R.C. § 2612(a)(1).
[40] I.R.C. § 2612(a)(2).
[41] I.R.C. § 2612(b).
[42] I.R.C. § 2613(a)(1). Accounting income is defined by § 643(b) as:
[T]he amount of income of the estate or trust for the taxable year determined under the terms of governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.
[43] I.R.C. § 2613(a)(1).
[44] I.R.C. § 2613(a)(2).
[45] I.R.C. § 2613(a)(3).
[46] I.R.C. § 2613(b)(1).
[47] *Id.*

present interests and powers of beneficiaries one generation below that of the grantor. These rules are as follows:

First, where two or more younger generation beneficiaries are assigned to the same generation, the transfer constituting the termination with respect to each is treated as occurring when the last such termination occurs.[48]

Second, where a younger generation beneficiary has both an interest and a power, or more than one interest or power, the termination of each such interest or power is treated as occurring when the last such termination occurs.[49]

Third, where there is a termination of a present interest or power of a younger generation beneficiary ("younger beneficiary") at a time when a younger generation beneficiary assigned to a higher generation ("older beneficiary") has a present interest or power, the taxable termination with respect to the younger beneficiary is treated as occurring when the termination of the last present interest or power of the older beneficiary occurs.[50] Regardless of the actual order of termination, the older beneficiary's termination is treated as having occurred prior to the younger beneficiary's.[51] Thus, the tax base used to determine the tax on the younger beneficiary's termination is reduced by the tax on the older beneficiary's termination.[52]

Fourth, where, immediately after the termination of the interest or power of a beneficiary, another beneficiary assigned to the same or a higher generation has a present interest or power arising as a result of such termination, the taxable termination will be postponed and treated as occurring as provided in sections 2613(b) (2) (A) and (C).[53]

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[48] I.R.C. § 2613(b)(2)(A). The subsection specifically provides, however, that the rule is subject to regulations which, according to the legislative history, are to be designed to avoid postponement of the generation-skipping tax by inserting "nominal transferees" or "nominal beneficiaries." H. REP., *supra* note 1, at 51, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3405. Additionally, § 2622 specifically provides that regulations are to provide the extent to which substantially separate and independent shares of different beneficiaries of one trust are to be treated as separate trusts. The proper interpretation of this provision will be made somewhat easier by reference to the regulations under § 663(c).

[49] I.R.C. § 2613(b)(2)(B). There is also a specific grant of authority to prescribe regulations in this subsection. The House Ways and Means Committee Report indicates that the purpose of such regulations will be to prevent postponement of the tax when the powers or interests held by a beneficiary are nominal or contingent. H. REP., *supra* note 1, at 51 n.6, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3405.

[50] I.R.C. § 2613(b)(2)(C)(i). A grant of regulatory authority was inserted in this subsection as well, presumably with the intent of preventing the termination of an interest or power held by a nominal "younger beneficiary" from postponing the tax.

[51] I.R.C. § 2613(b)(2)(C)(ii)(I).

[52] I.R.C. § 2613(b)(2)(C)(ii)(II). This special rule avoids a "gross up" and, therefore, double taxation, so that the generation-skipping tax will be essentially the same even though there is an unusual order of deaths.

[53] I.R.C. § 2613(b)(2)(D). This provision is designed to fill in the gaps left by Code §§ 2613(b)(2)(A), (C) when, for example, an interest or power arises in a beneficiary in the same or a higher generation as the beneficiary whose interest or power has terminated as the result of a pour-over clause or the exercise by a deceased beneficiary of a power of appointment. It should be noted that, by referring to subparagraphs (A) and (C), the "nominal beneficiary" rules which are to be established by regulation are incorporated in the application of subparagraph (D).

A special rule provides that, in the case of the termination of a power, the property transferred is deemed to be the property subject to the power immediately before the termination, and the tax is imposed on the value of the power itself rather than on the value of the trust property.[54] This treatment contrasts with that of taxable distributions and taxable terminations of interests, where the tax is imposed on the fair market value of the property transferred.[55] Where a beneficiary has multiple interests or powers which cease at different times, the tax base will include the cumulative value of the terminated interests and powers, not exceeding 100% of the value of the trust property.[56] Special rules also apply to coordinate taxable terminations with what otherwise would be concurrent taxable distributions[57] and to prevent the imposition of a double tax where there are two or more deemed transferors of the same trust property attributable to the same generation.[58]

C. *Exceptions to General Rules*

There are a number of exceptions to the application of the generation-skipping tax. Some are incorporated by definition in the statute itself; others apply in accordance with the special transition rules contained in the Act, and therefore will be applicable only for a limited period. It is the liberality of these exceptions that provides the estate planner with significant opportunities to minimize a client's ultimate tax exposure under the new law.

1. Grandchild Exclusion

The most important exception to the application of the generation-skipping tax is the grandchild exclusion. This exception excludes from the

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[54] I.R.C. § 2602(a); H. REP., *supra* note 1, at 53.

[55] I.R.C. § 2613(b)(4). It is not clear, however, whether one may rely on what otherwise would appear to be clear statutory language. While the House Report appears to confirm this interpretation in an example valuing the "property subject to the power" at $75,000 (15 years of accumulated but not exercised annual rights to withdraw the greater of 5 percent or $5,000 from a $90,000 trust), H. REP., *supra* note 1, at 54, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3408, the Conference Report interprets the property "subject to the power" as meaning the entire trust property (i.e. $90,000 in the above example), H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 618 (1976), *reprinted in* [1976] U.S. CODE CONG & AD. NEWS 4118, 4256-57 [hereinafter CONF. REP.]. If this is the result intended by the Conference Committee, query why the statutory language of § 2613(b)(4) does not say "entire trust property" instead of "property subject to the power" and, further, why the subsection is needed at all in light of the general language of § 2602(a).

[56] H. REP., *supra* note 1, at 54, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3408.

[57] Section 2613(b)(7)(A) provides that terminations take precedence over distributions if:

> (i) the death of an individual or any other occurrence is a taxable termination with respect to any property, and
>
> (ii) such occurrence also requires the distribution of part or all of such property in a distribution which would (but for this subparagraph) be a taxable distribution.

I.R.C. § 2613(b)(7)(A). This provision is probably unnecessary, however, since the terminating event will always precede the distribution.

[58] I.R.C. § 2613(b)(7)(B). This provision also contains a prohibition against tax avoidance through the use of what might otherwise be "creative" draftsmanship. *See* CONF. REP., *supra* note 55, at 619-20, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4257-59.

category of taxable distributions and taxable terminations the first $250,000 of property passing to grandchildren of the grantor of a generation-skipping trust through any one deemed transferor.[59] The exclusion is limited by the number of children of the grantor and it is cumulative; it must be applied against transfers to grandchildren in the order in which the transfers are made or deemed to be made.[60] Further, to qualify for the exclusion, the property transferred must vest in the grandchild[61] at the time of the transfer.[62] From the language of the statute, it is clear that the grandchild exclusion is not elective; rather, it must be applied on a cumulative basis as each qualifying transfer is made.[63]

2. Transfers Subject to Gift or Estate Tax

To the extent that any transfer is subject to the estate tax of chapter 11 or the gift tax of chapter 12, it is specifically not included in the definition of either "taxable distribution"[64] or "taxable termination."[65] These provisions assure that there will not be a double tax on any transfer of generation-skipping trust property.[66]

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[59] I.R.C. §§ 2613(a)(4)(A), (b)(5)(A), & (b)(6).

[60] The exclusion is to apply "to transfers from one or more trusts in the order in which such transfers are made or deemed made." I.R.C. § 2613(b)(6).

[61] *See* CONF. REP., *supra* note 55, at 618, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4256-57.

[62] In a situation where a single trust for a child is created by the transfer of marital trust property to a trust as the result of a failure of a surviving spouse to exercise a general power of appointment at death, the surviving spouse becomes the grantor of the property derived from the marital trust. As to transfers from such a trust to a grandchild on the death of the child, the question might arise whether there would be a $250,000 exclusion applicable to the trust property derived from the marital trust and another to the property derived from the non-marital trust. The House Ways and Means Committee "believe[d] that the income from a . . . ($250,000) trust should be sufficient to provide for the needs of each child, even where that child might be the victim of disability or other hardship." H. REP., *supra* note 1, at 53 n.8, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3407. Section 2613(b)(6) provides that the exclusion applies to each deemed transferor, not each trust. I.R.C. § 2613(b)(6). Therefore, since the deemed transferor of all of the trust property transferred to the grandchild in the example would be the child, only one exclusion would be available.

[63] This requirement is important for planning purposes, since disproportionate distributions made from a generation-skipping trust among a child's children while the child is living would benefit the grandchildren receiving the first $250,000 of trust property, while the others would receive no benefit from the exclusion.

[64] I.R.C. § 2613(a)(4)(B).

[65] I.R.C. § 2613(b)(5)(B).

[66] This exception is in accord with the Act's intent only to equate the passing of property in trust with successive outright transfers. See note 9 *supra*. An interesting, and perhaps unforeseen result of these exceptions is that, by careful planning, the tax burden can be shifted or even totally eliminated. For example, assume a grantor creates a trust of $175,000 for a grandson for life, giving the grandson a special power to appoint the trust property at death to or among his spouse and issue, with or without further powers of appointment, and providing that in default of exercise of the power the trust property will continue in further trust for the grandson's issue. If the grandson died without exercising the power, a taxable termination would occur and the generation-skipping tax would be imposed at that time. The grandson would be the deemed transferor, and the tax would be based on the $175,000 as if added to his estate. The grandson can postpone the imposition of the tax, however, by exercising the special power to give his spouse a present interest in the trust, such as the income for her life. By § 2613(b)(2)(A)—because of the special rule in § 2613(b)(2)(D)—the taxable termination would be postponed until the spouse's death. Although the tax would be computed

3. Future Interest or Power

The definitions of "taxable distribution"[67] and "taxable termination"[68] both provide specifically that future interests and future powers held by younger generation beneficiaries are excluded from consideration when determining if the generation-skipping rules apply. Thus, for a distribution from a trust to be a "taxable distribution," the trust must have younger generation beneficiaries assigned to two or more generations below the grantor and these beneficiaries must have present interests or powers in the trust. A "taxable termination" can never occur as the result of the termination of a future interest or power.

4. Special Rules

There will not be a taxable termination of any trust as long as the trust has a beneficiary who has a present interest or power and who is no more than one generation below the grantor.[69] Further, when no beneficiary with a present interest or power is assigned to the first generation below the grantor, there will be no taxable termination as long as there is a present interest or present power in an individual to whom a distribution would not be a "taxable distribution"—that is, so long as the younger generation beneficiaries with present interests or present powers all are assigned to only one generation.

5. Income Exception

As noted above,[70] the definition of "taxable distribution" contains an exception for distributions of accounting income. This exception stems from the requirement that, to be taxable, a distribution may not be out of the accounting income of the trust within the meaning of Code section 643(b). Section 2613(a)(2), however, is designed to prevent tax avoidance where principal in addition to income is distributed to younger generation beneficiaries of different generations.[71]

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in the same manner, the income flow from the trust would not be reduced until the death of the spouse. Such a postponement may not be necessary or desirable if the grandson has no other assets taxable for estate tax purposes, since the $47,000 credit (assuming his death occurred after 1980) would eliminate the tax altogether. I.R.C. § 2602(c)(3). If the grandson's taxable estate is large, however, he can substantially shift the burden, as well as the timing, by exercising his power to give his spouse the income for life and a general testamentary power of appointment. On her subsequent death, the entire trust property would be includible in her estate for estate tax purposes under § 2041 and none would be taxable under chapter 13, by § 2613(b)(5)(B). If her taxable estate were otherwise negligible, the credit would eliminate the tax in the grandson's generation.

[67] I.R.C. § 2613(a)(1).

[68] I.R.C. § 2613(b)(1).

[69] See text at notes 53-58 *supra*.

[70] See text at note 42 *supra*.

[71] Significantly, income and principal distributions to beneficiaries in different generations can be made in different taxable years to avoid the taxation of an income distribution to the lower generation beneficiary, providing that the trust has been drafted with sufficiently flexible powers.

6. Limited Power to Appoint Among Lineal Descendants

A significant aspect of the new law is that an individual trustee holding powers within the definition of the Act is considered as a beneficiary. In many cases, however, it will be unnecessary to give an individual trustee any more than the power to dispose of trust property among the grantor's lineal descendants who are in a generation younger than that of the trustee himself. In such a case, the new law treats the trustee as not having any power in the trust.[72] However, if the class of beneficiaries among whom an individual has either a present or a future power to dispose of income or principal is expanded to include, for example, a spouse, the exception does not apply.[73]

7. Transition Rules

Finally, Congress included a generous grandfather clause in the law for generation-skipping transfers.[74] The rules affecting generation-skipping transfers are generally applicable to transfers made after April 30, 1976. If, however, a trust was irrevocable as of April 30, 1976, generation-skipping amounts contributed to the trust prior to May 1, 1976 are not taxable.[75] Generation-skipping transfers made from trust corpus added to such a trust after April 30, 1976, however, will be subject to tax.

In the case of a will or a revocable trust in existence on April 30, 1976, the generation-skipping rules do not apply to subsequent transfers from corpus in the trust at that date if the grantor dies before January 1, 1982, and the will or trust is not amended after April 30, 1976.[76] If the grantor or testator is incompetent, the grace period will be extended for a period of two years after the disability is removed.[77]

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[72] I.R.C. § 2613(e).

[73] If an individual trustee is given the power to appoint trust property to a beneficiary in the trustee's own generation, the exeption would not apply. Note, however, that by having an individual trustee included as a beneficiary in the same generation as the "real" beneficiaries, the provisions of § 2613(b)(2) could be advantageous in that they could postpone imposition of the tax to the death of the trustee even though all the "real" beneficiaries had died. Query whether the regulations should provide in such a case that the trustee is only a "nominal" beneficiary.

[74] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2), 90 Stat. 1520. These provisions apply as well to generation-skipping trust equivalents. *Id.* § 2006(c)(3).

[75] A trust created by the exercise of a power of appointment granted by a grandfathered irrevocable trust will itself be protected, as long as the Rule Against Perpetuities applicable to the new trust is measured from the date of creation of the original trust. CONF. REP., *supra* note 55, at 621, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4259. Query whether property poured-over to a grandfathered irrevocable trust on the termination of another grandfathered trust on a date subsequent to April 30, 1976 will lose its protection. Under the precise language of the transition rule, the protection probably would be lost, although logic would seem to dictate it should not be. The regulations should provide specific guidance.

[76] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2)(B), 90 Stat. 1520.

[77] *Id.* The determination of whether an amendment to a grandfathered revocable trust, or a codicil to a grandfathered will, will create or increase the amount of a generation-skipping transfer is going to be difficult in many cases. The intent of the rule is to include in the generation-skipping tax base property transferred pursuant to a dispositive plan conceived and executed subsequent to the date on which it became public knowledge that the generation-skipping tax was more than the reformer's dream. Thus, technical or administra-

These transition rules protect from the generation-skipping tax wealth whose disposition was provided for before the effective date of the new provisions. By focusing on the wealth itself and not the existing provisions for disposition, the transition rules permit amendment to grandfathered generation-skipping trusts, without the loss of transition rule protection, so long as the amendment does not create or increase the amount of any generation-skipping transfer.

II. GENERATION-SKIPPING TAX IMPACT ON ESTATE PLANNING

The generation-skipping tax often will have a significant impact on estate planning in situations where, under prior law, a client would have been advised to make use of trusts or other generation-skipping devices. A "standard" estate plan for a wealthy client under prior law would provide for a marital deduction trust and a nonmarital or family trust for the benefit of the client's spouse, followed by a discretionary trust or separate trusts for the children for life and final distribution after the death of the children to the grandchildren when they reach age twenty-five. Under the new law, if the client's assets do not exceed $250,000 per child, the grandchild exclusion can shield the entire trust from the new tax, except to the extent that the assets appreciate after the client's death to an amount greater than $250,000 per child, valued at the time the property, or an interest in or a power over such property, passes to the grandchildren. Thus, the generation-skipping tax is of significance primarily in larger estates. The following examination is offered to demonstrate some of the planning devices that may be used to reduce or eliminate the generation-skipping tax on a large estate.

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tive amendments resulting in indirect increases in amounts transferred down several generations, such as a change in fiduciaries (potentially reducing fees) or a revision of a marital deduction formula (to reduce estate taxes), should not result in the loss of protection. It will be necessary to defer to the regulations, however, for the final interpretation of the legislative intent.

The transitional rules have created an additional problem for donors of revocable Massachusetts trusts and for their trustees. MASS. GEN. LAWS ANN. c. 62, § 10(a) (West 1969), provides that trust income, including capital gains, is subject to income tax in Massachusetts to the extent that the persons to whom it is payable, or for whose benefit it is accumulated, are inhabitants of Massachusetts, and that any such income accumulated for unborn or unascertained persons or persons with uncertain interests is taxed as if accumulated for the benefit of a known inhabitant of Massachusetts. Before the generation-skipping tax was enacted, a donor who moved out of state typically would revoke his trust and re-execute a new one in his new domicile and, even if the Massachusetts trustee was named as trustee of the new trust, income received by the new trust and accumulated for uncertain, unborn or unascertained beneficiaries would not be subject to the Massachusetts income tax, since the donor would not have been an inhabitant of Massachusetts at the time the trust was created. *Id.* § 10(c). Under § 2006(c)(2) of the Tax Reform Act, however, the re-executed trust would become subject to the generation-skipping tax provisions.

Accordingly, to avoid the generation-skipping tax as well as the unnecessary Massachusetts taxation of the accumulated income of a non-resident's trust, it has now become necessary for the trustee to resign in favor of an out-of-state trustee. This unfortunate loss of fiduciary business was undoubtedly unforeseen by Congress, but it is not likely that any amendment to chapter 13 of the Code will be made to provide that a re-execution of a trust solely for the purpose of moving the place of creation will not constitute the creation of a new generation-skipping trust.

A. *A Hypothetical Estate*

John Smith, age seventy, upon receiving a letter from his attorney summarizing the provisions of the Tax Reform Act of 1976, has made an appointment to review his entire estate plan, including his will and revocable trust. Several changes have occurred in his family and financial circumstances since his estate plan last was updated in 1974, and the attorney's letter confused him enough to provide the impetus for a complete review. At the conference the following facts were developed:

1. Assets

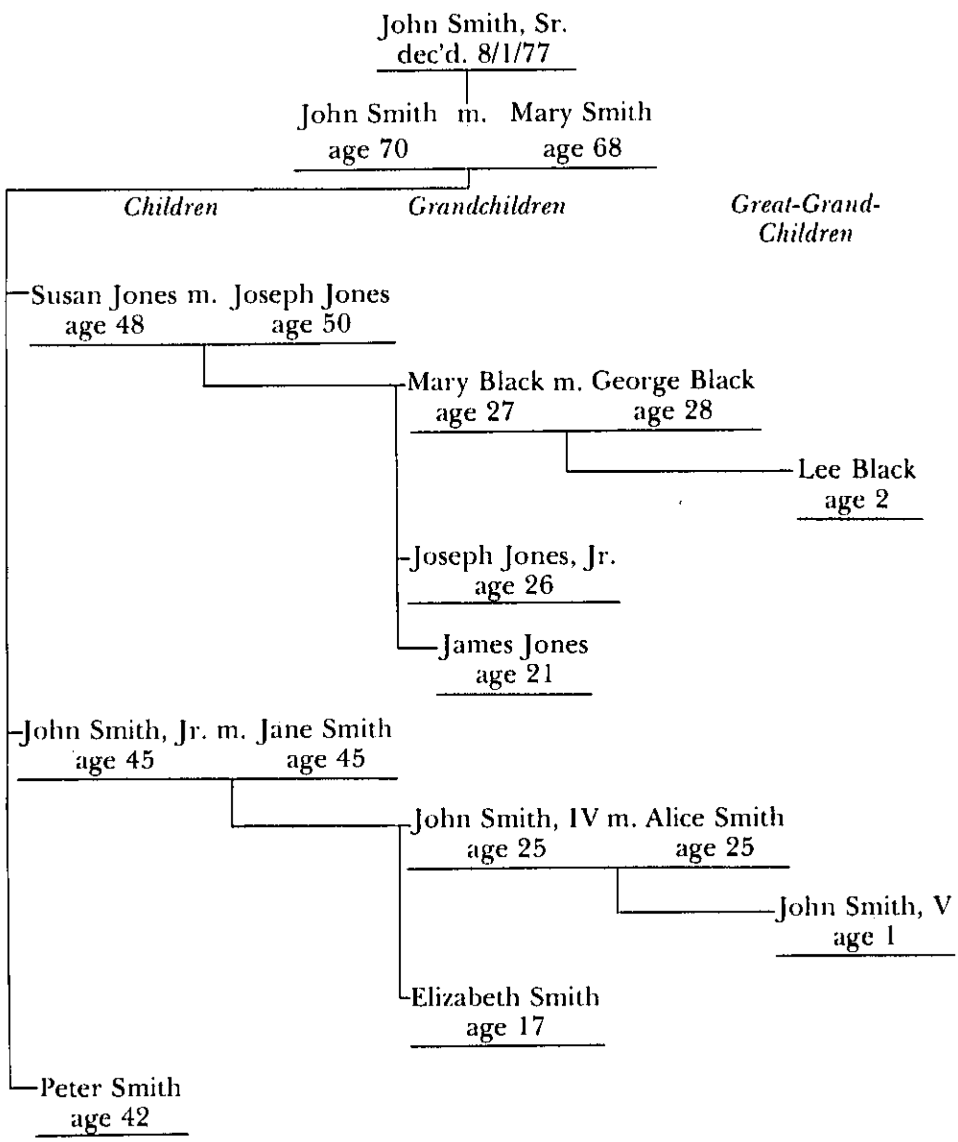
Using present market values, the Smiths own the following assets:

John Smith	
Working Farm, New Hampshire	$125,000
Closely Held Stock	100,000
Publicly Marketed Securities	1,500,000
Royalties (Annual Average Over Past Five Years Equals $2,000)	10,000
Tangibles	15,000
	$1,750,000
Mary Smith	
Publicly Marketed Securities	40,000
Tangibles	10,000
	50,000
Joint (all consideration furnished by John Smith)	
Residence in Massachusetts	225,000
Savings Account	20,000
Checking Account	5,000
	250,000
Total Taxable Assets	$2,050,000

In addition, at the time of his father's death on August 1, 1977, Mr. Smith became the primary income beneficiary of a testamentary trust created by the will of his mother, who died in 1965. The trustees of this trust have the discretion to pay income and principal among Mr. Smith and his issue, and Mr. Smith has a limited testamentary power to appoint the principal in favor of his issue and their spouses. In default of exercise of this appointment power, the trust property, currently valued at $200,000, will be divided into separate trusts for Mr. Smith's living children for their lives and, then, each child's trust will be distributed to his or her issue by right of representation subject to continuing trusts to age twenty-one.

2. Family Tree

Since 1974, Mr. Smith's father has died, and two great-grandchildren have been added to the family. The family tree is, therefore, as follows:



3. Present Estate Plan

Mr. Smith's present estate plan, executed in 1974, consists of a revocable living trust and a pour-over will. The trust has not yet been funded, for Mr. Smith has been active and alert and has wished to continue managing his own assets as long as he is able.

a. *Will.* Mr. Smith's will leaves all of his tangible personal property and real estate to Mrs. Smith, and directs that the remainder of his estate, after satisfaction of his last debts, funeral expenses, and the expenses of administering his estate and estate taxes, be poured-over to his trust to be held, administered and disposed of in accordance with the provisions of the trust as amended at the time of his death.

Mr. Smith's will does not exercise the limited power of appointment granted to him in his mother's 1965 trust, since the default provisions of that trust conform with his wishes.

b. *Revocable Trust.* Mr. Smith's trust directs that, on his death, the following legacies are to be paid: $50,000 to each living child, $20,000 to each living grandchild and $5,000 to his alma mater, Yale University.

An amount equal to the maximum allowable marital deduction, less other amounts passing to Mrs. Smith and qualifying for the marital deduction, is to be transferred to a marital deduction trust which provides for payment of all the income, and so much of the principal as the trustees in their discretion determine, to Mrs. Smith for her life, and which gives her a general testamentary power of appointment. In default of her exercise of this power, the marital trust property will be added to a family trust comprised of the assets of the revocable trust remaining after the initial transfer to the marital deduction trust. The family trust provides for discretionary payments of income and principal to and among Mrs. Smith and their issue of all generations. Mrs. Smith is given a limited testamentary power to appoint the family trust property to or among her issue outright or in further trust.

In default of exercise of Mrs. Smith's power of appointment over the family trust, upon the death of the survivor of Mr. and Mrs. Smith, the remaining trust property will be divided into equal shares, one for each living child and one for the issue of each deceased child. Each child's share will be held in a separate trust which provides for discretionary payments of income and principal to and among that child and his or her issue of all generations as long as that child is living. Final distribution of each trust will occur on the death of the child for whom it was established. The property in each child's trust will then be distributed to his or her issue by right of representation, subject to continuing trusts for beneficiaries under the age of twenty-five.

c. *Trusts for Grandchildren.* For each grandchild who has entered college Mr. Smith has, in the past, established an irrevocable trust in the amount of $50,000. Each of these four trusts provides for the discretionary payment of income and principal to the grandchild, primarily for educational purposes. The trust for each grandchild is to terminate on his or her death, with the principal to be distributed to his or her issue by right of representation, subject to continuing trusts for beneficiaries under age twenty-five. Appropriate gift tax returns were filed when each gift was made, the latest in 1974.

d. *Gifts to Children.* For many years Mr. Smith has also made cash gifts at Christmas in the amount of $6,000 for each child. Mrs. Smith has always joined in making these gifts so that they have not resulted in the payment of any gift tax.[78] Thus, the only gifts for which returns were required were those made to the grandchildren's trusts for educational purposes, totalling $200,000.

4. Revised Family Circumstances, Needs, and Desires

During the conference with his attorney, Mr. Smith related the following information respecting his family situation and his estate planning desires.

a. *Legacy for Son.* Mr. Smith's youngest son, Peter, has been found to have contracted a terminal illness, and is expected to live only a few more years. Peter has been materially successful and has built his own estate to approximately $300,000. Accordingly, Mr. Smith desires to eliminate the legacy to Peter, since both agree that Peter will not need the attendant funds, and since unnecessary estate taxes would be incurred on Peter's death when, as planned, his estate will pass to his brother and sister.

b. *Irrevocable Trust for Granddaughter.* Mr. Smith's granddaughter, Elizabeth, has just been accepted as a freshman at Yale. As a continuation of his program of gift giving, Mr. Smith desires to establish immediately a $50,000 trust for her benefit, upon the same terms as the four trusts previously created for his other grandchildren's education.

c. *Charitable Legacy.* Since Elizabeth is the first of his issue to go to Yale, and since Mr. Smith wishes to contribute to the Campaign for Yale in any event, he wants to increase the legacy payable to Yale at his death from $5,000 to $50,000.

d. *Legacies for Great-Grandchildren.* Mr. Smith also want to add legacies in the amount of $5,000 to each great-grandchild living at his death. However, he recently has learned that his namesake, John Smith V, was born with brain damage and probably will need special medical attention all his life. John does have a normal life expectancy, however, so Mr. Smith wants advice on how he can provide for this special situation.

e. *Powers of Appointment for Children.* Mr. Smith believes that the designation of his children's issues as the final distributees of the 1974 trust is too restrictive an end limitation. He now wishes to give each child a testamentary power to appoint the principal of his or her trust to any one or more of Mr. Smith's issue and their spouses.

f. *Trustees and Executors.* In his 1974 trust instruments and will, Mr. Smith designated his attorney, who is sixty years old, and his son, John, Jr., age forty-five, as his executors and trustees. The attorney's partner, age fifty, is the attorney's designated successor as executor and trustee, and Peter Smith, age forty-two, is John, Jr.'s successor. Since it is now questionable whether Peter will outlive him, Mr. Smith desires to change the successor executor and trustee designation to provide that the attorney's partner, with whom he has become extremely close, will succeed as sole executor and sole trustee.

[78] See I.R.C. § 2513 which permits gift splitting by spouses. By aggregating each's $3,000 per year per donee exclusion, no gift tax is ever due on the $6,000 gift.

The trustees of the 1965 trust established by Mr. Smith's mother are his attorney and John, Jr., and the attorney's partner is the successor and eventually the sole trustee. The same individuals are the trustees of the four grandchildren's trusts. Mr. Smith, thinking that administrative convenience and savings might be achieved, wants advice as to whether the 1965 trust could be combined with his own and managed as a consolidated fund.

g. *Legal Life Estate.* Mr. Smith's will presently provides that the farm in New Hampshire will pass to his wife if she survives him. This is a working farm which has been in his family for several generations and has been the source of much pleasure over the years. In 1974, when his will was executed, he contemplated that if his wife did not survive him, the farm would be sold and the proceeds added to his revocable trust. Such a sale would be a material financial benefit to the estate because the farm is near a fast growing town and will be prime land for development in the forseeable future. Now, however, John, Jr. has indicated that he and his children strongly desire to keep the farm, particularly as it is well suited to the needs of John, V. Thus, Mr. Smith would like to provide that John, Jr. receive the farm as a part of his share of the entire estate, and that the farm continue in his family to provide a place to bring up John, V. Mr. Smith has considered putting the farm in his trust, but he realizes that to do so could create unnecessary administrative difficulties for the trustees, and he would like to have a legal life estate examined as an alternative.

Against this background, Mr. Smith has asked that his entire estate plan be reviewed, particularly in order to evaluate the effects of the generation-skipping tax provisions of the Tax Reform Act of 1976.

B. *Consequences of Amending Estate Plan*

Since Mr. Smith's present revocable trust and his mother's 1965 trust provide for the disposition of property to beneficiaries assigned to more than one generation, they are both generation-skipping trusts. Accordingly, it is necessary to determine first whether and to what extent the generation-skipping tax applies to transfers from the trusts. If all of the transfers under the existing plan are exempt from the tax, the client must make the determination whether the changes in his family circumstances provide sufficiently compelling grounds to make alterations which eventually might generate generation-skipping tax liability.

1. Transition Rules

a. *Irrevocable Trusts.* As long as no principal is added to the 1965 trust created by Mr. Smith's mother and the four grandchildren's trusts created by Mr. Smith prior to April 30, 1976, no distribution made either during their continuance or upon their termination will be subject to the generation-skipping tax;[79] this results because these pre-April 30, 1976 generation-skipping trusts are grandfathered by the transition rules. Moreover, if Mr. Smith exercises his power of appointment over the 1965

[79] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2)(A), 90 Stat. 1520.

trust to create additional trusts, the generation-skipping tax still will not apply as long as the termination of any new trust is required to be within the time allowed by the Rule Against Perpetuities as measured from 1965.[80] Conversely, if Mr. Smith were to add to any of the irrevocable trusts, either by lifetime gifts or by an amendment to his will or 1974 trust, distributions of such additional property from the recipient trust would be subject to the new law.[81] Although the existing trust property would not be "tainted" by these additions, the trustees would have to keep the additional property segregated on their books, since any appreciation in the value of the latter property presumably would carry the "taint."[82]

b. *Revocable Trust.* Under the transition rules,[83] as long as Mr. Smith's 1974 trust is not amended after April 30, 1976 so as to create or increase the amount of any generation-skipping transfer, the generation-skipping tax will not apply to any distribution of the trust property made during its term or on termination. This protection, however, will be lost on January 1, 1982 if Mr. Smith is still living on that day.[84] Unfortunately, the transition rule refers to generation-skipping transfers "pursuant to a will (or revocable trust)" and does not specifically contemplate an estate plan which combines a revocable trust with a pour-over will.[85] Until regulations are published, however, it is probably safest to assume that the will and revocable trust will be read together and, therefore, that an amendment to one or the other creating or increasing the amount of any generation-skipping transfer will result in the loss of protection from the tax for the entire plan.

c. *Legal Life Estate.* If Mr. Smith changes his will to provide that, if Mrs. Smith does not survive him, the farm is to be held on a legal life estate for John, Jr. with the remainder to his issue, and makes no other changes, it would appear that a new generation-skipping transfer would be created if Mrs. Smith predeceases Mr. Smith. The interest of John, Jr. and his issue would then vest and they would comprise two generations of beneficiaries in generations younger than the grantor, Mr. Smith. However, it could be argued that since, under the arrangement already in existence, if Mrs. Smith predeceases, the property would be sold and the proceeds used to fund the generation-skipping revocable trust, the amendment effectively would neither create a new generation-skipping transfer nor increase the

[80] See note 75 *supra*.

[81] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2)(B), 90 Stat. 1520.

[82] Although the interpretation of the rule appears logical, it may prove contrary to the regulations when issued. If this interpretation is correct, however, it would appear probable that any decline in the value of property added to a grandfathered trust would reduce the generation-skipping tax burden.

[83] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2)(A), 90 Stat. 1520.

[84] *Id.* § 2006(c)(2)(B).

[85] Nor does the rule contemplate a plan by which a will directs the pour-over of probate property to a grandfathered irrevocable trust. Query, for example, whether a legacy in a pre-1976 will of a decedent who dies in 1980 to an irrevocable generation-skipping trust created in 1970 would be protected under § 2006(c)(2)(B) or would be considered an "addition" under § 2006(c)(2)(A).

total value of the interests of all beneficiaries in any generation below that of Mr. Smith. The Conference Committee Report indicates that this argument probably would be successful, particularly if the will and revocable trust are consolidated for purposes of the transition rule.[86]

2. Generation Assignments

On the assumption that Mr. Smith will desire to amend his estate plan better to reflect the changes in his circumstances, it is necessary to know the potential generation assignment of each of the beneficiaries of the estate plan in order to plan properly under chapters 11, 12 and 13 of the Code.

a. *Grantor.* To the extent that he contributed property to a generation-skipping trust or generation-skipping trust equivalent,[87] Mr. Smith will be the grantor of any generation-skipping transfer. Assuming Mrs. Smith survives him, however, on her death she presumably would become the grantor of the marital deduction trust property, since she will have been treated as the owner of this property for estate tax purposes.

b. *Beneficiaries.* Mrs. Smith, regardless of her age, automatically is assigned to Mr. Smith's generation. The Smiths' three children are younger generation beneficiaries assigned to the first generation below Mr. Smith. The five grandchildren, also younger generation beneficiaries, are assigned to the second generation below the grantor, and so on.[88]

c. *Spouses of Issue.* Regardless of their age, the spouse of each lineal descendant of Mr. Smith is assigned to that descendant's generation.

d. *Trustees.* The trustees, who will have presently exercisable powers to alter the beneficial enjoyment of the revocable trust, will be considered as beneficiaries.[89] Mr. Smith's attorney is only ten years younger than Mr. Smith and accordingly would be assigned to his generation. The attorney's partner, however, is more than twelve and one half years younger than Mr. Smith, and under the assignment rules would be assigned to the first younger generation.[90] The assignment of John, Jr. in his capacity as trustee would not change from his assignment, as a child, to the first younger generation.

3. Dispositions Under Will

a. *Tangible Personal Property.* Since Mr. Smith's tangibles will pass outright to his wife, the transfer will not be considered to be a generation-skipping transfer. This would be the case for any outright transfer even if the recipients were grandchildren.

b. *Real Estate.* As with the tangibles, if the real estate, including the farm, passes outright to Mrs. Smith or to the children, there will be no

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[86] CONF. REP., *supra* note 55, at 620-21, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4258-59.

[87] A life estate in the farm, for example, would be considered a generation-skipping trust equivalent.

[88] *See* I.R.C. § 2611(c)(1).

[89] *See* I.R.C. § 2613(d)(2).

[90] *See* I.R.C. § 2611(c)(5)(B).

generation-skipping transfer. If, however, Mr. Smith creates the contemplated legal life estate for his son John, Jr., the arrangement will be a generation-skipping trust equivalent. Accordingly, on the death of John, Jr., the transfer to the latter's issue would be a generation-skipping transfer subject to the new tax, since the arrangment will split benefits between two generations younger than Mr. Smith's. Concomitantly, this transfer would qualify for the grandchild exclusion.[91]

Since no income or principal of the real estate could be paid to anyone other than John, Jr., no taxable distributions could take place during his life because the generation-skipping tax reaches only distributions of trust corpus, not distributions of trust income. If one of John, Jr.'s children should predecease John, Jr., the postponement rules would suspend the taxable termination until John, Jr.'s death, when the termination of the life estate would require outright distribution of the property to his issue.[92] At that point, the grandchild exclusion would apply to the termination distribution of the real estate, and the children of any deceased child of John, Jr., great-grandchildren of the grantor, would receive the benefit of the exclusion. It may be important to note, with respect to this property, that the special use valuation rules of Code section 2032A will not apply for purposes of computing the generation-skipping tax. Since these rules are virtually unworkable even where applicable,[93] this caveat probably will have little weight in determining whether to dispose of the farm in a manner which will be taxable in John, Jr.'s estate rather than by giving him a life estate.

c. *Residuary Estate.* The transfer of Mr. Smith's residuary estate to the trustees of his revocable trust will not be considered to be a generation-skipping transfer, even if the transition rule protection is lost, because the transfer is from the estate and not from a generation-skipping trust. Furthermore, transfers from the probate estate are subject to estate taxation and hence would be exempt from any generation-skipping tax in any event.[94] If Mr. Smith funds the revocable trust during his lifetime, presumably there would be no resultant "increase" in the amount of any generation-skipping transfer, since funding was already directed by his will to take place. This conclusion is consistent with the view that a revocable trust and pour-over will should be treated as consolidated for purposes of the transition rule.[95]

4. Legacies from Revocable Trust

a. *Taxability.* Even though Mr. Smith's legacies to his children are payable from the trust, they will not be considered to be generation-skipping transfers because they are payble outright. Further, even though the legacies to the grandchildren and great-grandchildren seem to be tax-

[91] This analysis assumes that the protection under the transition rule will have been lost.
[92] *See* I.R.C. § 2613(b)(1).
[93] *See* S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION 1086-96 (1977).
[94] I.R.C. § 2613(b)(5)(B).
[95] See text at note 86 *supra*.

able distributions, since they are non-income distributions, the transfers will be subject to estate taxes in Mr. Smith's estate and are therefore specifically excluded.[96]

b. *Transition Rule.* Mr. Smith's present trust provides for a total of $255,000 of legacies to his children, grandchildren and Yale. If his trust is amended to eliminate the legacy for his son, Peter, to add a $5,000 legacy for his granddaughter, Lee, and to increase the legacy to Yale to $50,000, the total would still be $255,000. Assuming no other changes to his estate plan, the question arises whether these changes would constitute an amendment which would result in the increase in the amount of any generation-skipping transfer. Since the total dollar amount of the legacies is the same, the net effect would be a reduction of estate taxes because of the increased charitable deduction resulting from the additional bequest to Yale, and an increase in the dollars available to fund generation-skipping trusts. However, such an indirect increase appears not to be within the intended scope of taxable generation-skipping transfers and, assuming that there are no other changes, it should not result in the loss of the protection granted by the transition rule.[97] A precise interpretation of the rule would indicate that a decrease of the total amount of the legacies would result in a total loss of protection; but logic and fairness, as well as conformity with the rule relating to irrevocable trusts, would seem to dictate the conclusion that the "taint" should apply only to the resulting increase in generation-skipping transfers.

5. Marital Deduction Trust

Even if the protection of the transition rule is lost for the revocable trust, the marital deduction trust nevertheless would not be a generation-skipping trust. Mrs. Smith, by definition, has the only current beneficial interest in the trust and she is in the grantor's generation. Even though one, and eventually both trustees will be in a younger generation, and the trustees have the power to invade principal for Mrs. Smith, who is not a lineal descendant of the grantor assigned to a younger generation than that of both trustees, nevertheless, no trustee will be in a younger generation than that of the grantor's children. By definition, a generation-skipping trust must have younger generation beneficiaries assigned to more than one generation. The death of any of the Smiths' other issue during the term of the marital trust would not be a taxable termination, since none of them would have had a present interest or power until Mrs. Smith's death, and the termination of a contingent, or future, interest is never taxable. The transfer occurring on Mrs. Smith's death, whether she exercises her power of appointment or allows the marital trust property to pass in default of the exercise, would be subject to the estate tax and, accordingly, would be exempt from the generation-skipping tax by specific exclusion.

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[96] I.R.C. § 2613(b)(5)(B).

[97] *See* CONF. REP., *supra* note 55, at 620-21, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4258-59.

6. Family Trust

This trust, because it has younger generation beneficiaries who are assigned to more than one generation below Mr. Smith, is a classic generation-skipping trust. Because the trust was already in existence on April 30, 1976, however, it is protected by the transition rules. Accordingly, whether transfers from the trust will incur the generation-skipping tax if Mr. Smith now amends the trust depends on whether the transition rule protection is lost, who the recipients of trust property are, and the type of trust property transferred.

a. *Transition Rule.* There is a technical possibility that the reduction in estate taxes brought about by the increase to the charitable deduction and the potential decrease of trustees' fees brought about by the reduction from two trustees to one could result in the loss of this trust's grandfathered status. This, however, would not appear to be within the intent of the law.[98] Nevertheless, if Mr. Smith amends the trust to give his children limited powers to appoint the trust principal at their deaths, the transition rule protection would be lost since there would then be a possibility, under the power, of increasing the number of generations which might be skipped.

b. *Beneficiaries.* Mrs. Smith and all of the Smiths' issue will be treated as having present interests in the trust, since they are all permissible recipients of income and principal. The trustees also have present powers in the trust, in that they may alter the beneficial enjoyment of income and principal by distributing income or principal to Mrs. Smith or any of the Smiths' issue.

c. *Distributions.* Even assuming the protection against the generation-skipping tax is lost by adding the power of appointment in his children, not all distributions from the trust during Mrs. Smith's lifetime would be taxed as generation-skipping transfers. For example, all distributions of current income to Mrs. Smith or to one or more of their children would be exempt under the income exception.[99] Additionally, all distributions of current income to one or more of the grandchildren, or more remote descendants, would be similarly exempt, except to the extent that distributions of principal in the same taxable year are made to younger generation beneficiaries assigned to an older younger generation. In the latter case, the income would be deemed to have been distributed to the older younger generation beneficiaries first, and the balance of the distributions, less any remaining income, would be considered to be principal and, since distributed to a beneficiary two or more generations below Mr. Smith, would be subject to the tax.[100] Thus, all distributions of principal, including distributions of income which are deemed to be distributions of principal, to a grandchild or lower generation beneficiary will be subject to the tax, but all distributions of principal to Mrs. Smith or to any child would be exempt.[101]

[98] See text at note 97 *supra*.
[99] *See* I.R.C. § 2613(a)(1).
[100] *See* I.R.C. § 2613(a)(2).
[101] If at the time of the distribution from the family trust to a grandchild there are no children living, the distribution will be subject to the tax only if a "series of related transfers" takes place. I.R.C. § 2613(c)(2). Presumably this means that, since the unusual order of termination provision in § 2613(b)(2)(C) would have postponed the imposition of the tax on each

d. *Termination of Interests or Powers.* There would not be a taxable termination on Mrs. Smith's death unless one or more of the children have predeceased her leaving issue then living, since no taxable termination can occur as long as there is a beneficiary with a present interest or present power who is no more than one generation below Mr. Smith.

If, as expected, Mr. Smith's ailing son Peter predeceases Mrs. Smith, the termination of his interest in the family trust would not be taxable at the time of his death due to the postponement provisions.[102] Instead, the taxable termination would be suspended, with taxation postponed either until Mrs. Smith's death or, if the Smiths' children are then still living, until the termination of their present interests upon the division of the family trust into equal shares for the children.

If John, Jr. should predecease Mrs. Smith leaving issue surviving her, the termination of the family trust on her death, which would result in one third of the trust property being distributable to John, Jr.'s issue subject to continuing trusts,[103] would render the tax applicable to that third, subject to the grandchild exclusion.[104] However, Mrs. Smith could postpone the imposition of the tax on the excess of the one third over the $250,000 grandchild exclusion by exercising her limited power of appointment to the extent of such excess in favor of her living children. She then could equalize for the resulting loss to John, Jr.'s children by exercising her general power of appointment over the marital trust to create a new trust for their benefit. By keeping the excess from John, Jr.'s one third share of the family trust over $250,000 in her children's generation and creating a new trust directly for the benefit of the grandchildren's generation, Mrs. Smith would avoid a taxable termination.

If all three children and the attorney's partner, the successor trustee of the family trust, predecease Mrs. Smith, her death will have immediate tax consequences because the terminations which were suspended at the time of the children's deaths will be treated as occurring then, unless she elects to postpone the imposition of the tax by exercising her general power of appointment. Thus, it is not the termination of Mrs. Smith's interest that incurs the tax, because regardless of whether any younger

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child's death prior to termination, the distribution to a grandchild would terminate the postponement period as to the amount distributed and it would now be subject to the tax (and the grandchild exclusion). See COVEY, *supra* note 5, at 62, for a discussion of this rule, including his inference from other provisions in chapter 13 that, in some cases, such distributions might be exempt from the tax. The regulations, it is hoped, will clarify this ambiguity.

[102] I.R.C. § 2613(b)(1).

[103] With respect to the continuing trusts for the grandchildren, it must be remembered that the $250,000 exclusion will not be available unless the property passes to or for the benefit of the grandchildren in a manner that will "vest" in them for estate tax purposes. Granting them a general power of appointment would be sufficient for this purpose, even if they should happen not to be competent to exercise the power at their deaths.

[104] If Peter is the only child to predecease Mrs. Smith, there will only be two grandchild exclusions available upon the termination of the interests of Mrs. Smith and the other children, since the exclusion is allowed only on a "per deemed transferor" basis and Peter will not have been a deemed transferor as to any property passing to his nieces or nephews. *See* I.R.C. §§ 2612, 2613(b)(6). Further, even if a separate trust were established for Peter on Mr. Smith's death, with the remainder to Susan's and John, Jr.'s children, Susan and John, Jr. would be the deemed transferors of the property passing to their respective children and a third exclusion would still not be available.

generation beneficiary had present interests or powers during her lifetime, her death will not, by itself, have any generation-skipping tax consequences.[105]

The death or resignation of a younger generation individual trustee would result in a suspended taxable termination. The suspension would continue until the death of the survivor of Mrs. Smith and the first child who dies leaving issue, when the deceased child's share of the trust property would pass to his or her issue.

7. Trusts for Children

These trusts are also classic generation-skipping trusts, and the considerations with respect to the transition rule and the beneficiaries applicable to the family trust apply to these trusts as well.

a. *Distributions.* If each trust were created for the sole benefit of a child, no distribution of income or principal would be subject to the generation-skipping tax, since a taxable distribution for the purposes of this tax by definition cannot be made to a child. Mr. Smith's trust, however, provides that the trustees have the discretion to pay income or principal to the child and the child's issue. Thus, even though no distributions to the child would be subject to the tax, distributions of principal and distributions of income which are deemed to be distributions of principal to grandchildren or more remote descendants would be taxable, subject to the grandchild exclusion. To the extent not distributed to a child, however, payments of current trust income to a grandchild or more remote descendant would not be considered taxable distributions since only corpus distributions are taxable.

b. *Termination of Interests or Powers.* If a grandchild should die prior to the death of the child for whom the trust was established, there would be a suspended taxable termination resulting in the imposition of the tax on the death of the child.

As expected, upon the death of the child the trust property would be fully subject to the generation-skipping tax, unless exempted by the grandchild exclusion.[106] If, however, either John, Jr. or the attorney's partner is acting as trustee, the suspension provisions will postpone the tax until such trustee's death. Since the trustees' powers over this trust can be exercised in favor of lineal descendants of the grantor assigned to the trustees' generation as well as to lower generations, section 2613(e) will not apply; thus, the trustees will be considered to be beneficiaries and the suspension rules will postpone the tax.

If Mr. Smith were to direct the creation of a single spray trust for the benefit of all the Smith children on Mrs. Smith's death instead of separate

[105] This conclusion must be qualified, however, by the caveat that if the division of the family trust property into separate children's trusts should be considered by the regulations to be a taxable termination (subject to the suspension rules), then the death of a child during the term of the family trust would generate a larger tax liability than would be imposed if such death occurred after Mrs. Smith's death. This view prescinds from the fact that at the time of the earlier death, the deceased child's interest was in the entire trust property whereas after the division it was in only a portion—in this case, one third.

[106] See note 103 *supra*.

trusts, the postponement provisions would delay the application of the tax until the death of the last survivor of the children and the younger generation trustees.

When the separate shares of John, Jr. and Susan pass to their respective issue, the amount of property will exceed $250,000 per deemed transferor, and will be taxable to the extent of such excess. However, powers of appointment granted to the two children can be used to postpone the tax or even eliminate it altogether. For example, Susan could exercise her power over all but $250,000 to create a present interest, such as the income for life, in her husband, Joseph. If he outlives her, this arrangement would postpone until his death the taxable termination that otherwise would occur on her death. If Joseph's estate were small, Susan could exercise her power to give him the income for life and a general power of appointment, and the property subject to the power would be exempt from the generation-skipping tax on his death, since it would be includible in his taxable estate for estate tax purposes. A power given to Joseph to withdraw the greater of $5,000 or 5% of the trust property each year also would shift taxability to his estate to the extent he exercises this power.

8. Grandchildren's Irrevocable Trusts

If not augmented by additional corpus, the four grandchildren's trusts, established prior to 1976 upon each grandchild's entrance into college, will retain their protection from the generation-skipping tax forever, by virtue of the transition rules. By contrast, all of the new rules will apply to the new trust Mr. Smith now desires to create for his granddaughter, Elizabeth.

a. *Distributions.* During Elizabeth's lifetime there will be no younger generation beneficiary in an older generation who has a present interest or power in the trust; the power in the trustees to distribute income or principal among Elizabeth and her lineal descendants does not constitute a power for the purposes of the new law.[107] Accordingly, no distribution of income or principal to her during her life will be subject to the generation-skipping tax. Distributions of current income to her issue during her life also will not incur the tax, except to the extent that principal distributions are made during the same tax year to any ancestor of that distributee.[108] Distributions of principal, however, during Elizabeth's life to any of her issue will be subject to the tax.

b. *Termination of Interests or Powers.* On Elizabeth's death, a taxable termination under section 2613(b)(1) would occur, assuming she is survived by issue and regardless of whether she is survived by one of the individual trustees. If Elizabeth gives birth to a younger generation of trust beneficiaries, her death will trigger taxation because it will mark the termination of the interest of an older younger generation beneficiary of the trust. If, however, Elizabeth dies without issue, and the trust property passes to another grandchild or someone in a higher generation who has a present power or interest arising as a result of the grandchild's death, the post-

[107] *See* I.R.C. § 2613(e).
[108] *See* I.R.C. § 2613(b).

ponement provisions will prevent the tax from being applied until the termination of these present interests. If any of Elizabeth's issue should die during her lifetime, each such death would cause a suspended taxable termination, since all of her issue would have present interests. If any other contingent beneficiary should die during Elizabeth's lifetime, no taxable termination would occur then because no such younger generation beneficiary would have present interests or powers during Elizabeth's life.

The death of a trustee, regardless of generation assignment, during Elizabeth's life would not cause a suspended taxable termination, since the trustees' power to distribute income and principal among lineal descendants of the grantor in generations lower than their own are not taken into account for purposes of the postponement provisions. Similarly, if an individual trustee assigned to the same generation as Elizabeth's parents is still living on her death, the termination caused by Elizabeth's death would not be postponed.

9. 1965 Irrevocable Trust

Since this trust is grandfathered under the transition rules, it should not be added to by a pour-over provision in Mr. Smith's will or revocable trust. Under the transition rules, however, a new trust could be created by Mr. Smith's exercise of his power of appointment which, so long as it does not have additional interests which postpone the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the old trust, will continue to be protected from the generation-skipping tax.[109] Accordingly, Mr. Smith could exercise his power and create a trust for Mrs. Smith's life, to be followed by separate trusts for his grandchildren or even great-grandchildren, and as long as the Rule Against Perpetuities was still required to be measured from 1965, the property in the 1965 trust could be passed down through two or three generations without incurring the tax. This would seem to be an ideal way of solving Mr. Smith's problem of how to provide for his disabled grandson, John, V.

C. *Recommended Estate Plan*

Having received the preceding explanation of the generation-skipping tax and its effect on his estate plan after making the changes he wishes to make, Mr. Smith has decided to proceed with the updating of his plan. He expects to live beyond 1981, when his will and revocable trust will become subject to the generation-skipping tax, but he believes that the application of chapter 13 will not materially frustrate his intentions. The following are the changes that might be recommended by his attorney to effectuate Mr. Smith's desires to minimize the impact of the generation-skipping tax.

[109] CONF. REP., *supra* note 55, at 620-21, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4258-59.

1. Will

No provisions should be added to the will which would direct the pour-over of any of Mr. Smith's property to an irrevocable grandfathered generation-skipping trust. Any such pour-over transfers would be subject to generation-skipping tax.[110] The present provisions of the will[111] therefore should be used in the new will with the following changes.

a. *Farm.* For generation-skipping tax purposes, it does not matter whether the farm passes in trust or subject to a legal life estate for John, Jr. Although the value of this property probably will continue to increase because of its potential for development, it is nevertheless of greater importance that it remain in John, Jr.'s family than that the special use valuation rules of Code section 2032A remain available. Insofar as holding real estate is concerned, a legal life estate would be more advantageous than a trust. Accordingly, the farm should be left to John, Jr. for life, with no power in him to sell in order to preserve it for his issue, and his issue should be the remaindermen by right of representation.

b. *Power of Appointment over 1965 Irrevocable Trust.* Mr. Smith should exercise his limited power of appointment over his mother's trust property by creating a new trust for the benefit of his great-grandson, John, V. The trust provisions could be set out in his will or in a separate trust instrument. If a separate trust is used, it would be "dry" until Mr. Smith's death, and his will should include a simple pour-over clause through which the trust would be funded. The trust should provide for discretionary payments of income and principal to or for the benefit of John, V, and, in order to avoid problems with the applicable Rule Against Perpetuities, should be specifically directed to terminate twenty-one years following the death of the survivor of John and Mary Smith and all of their issue living on the date of creation of the 1965 trust.[112] If John, V should outlive this period, provision should be made to permit the termination distribution to be made to his guardian or conservator. If, however, he should die prior to the required termination, the trust property should be made distributable to the Smith's other great-grandchildren living at that time, or the issue of any great-grandchildren who are deceased.

c. *Royalties.* Since the income tax deduction allowed under section 691(c) of the Code for income in respect of a decedent has been extended to allow the deduction when such income has been taxed under the generation-skipping tax,[113] there is no reason that Mr. Smith's royalties

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[110] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(c)(2)(A), 90 Stat. 1520.

[111] See p. 448 *supra*.

[112] See note 75 *supra*. If the Rule Against Perpetuities is measured from the date of the creation of the 1965 trust, the transition rule protection will not be lost.

[113] I.R.C. § 691(c)(3) provides:

> Special rule for generation-skipping transfers.—For purposes of this section—
>
> (A) the tax imposed by section 2601 or any State inheritance tax described in section 2602(c)(5)(C) on any generation-skipping transfer shall be treated as a tax imposed by section 2001 on the estate of the deemed transferor (as defined in section 2612(a));
>
> (B) any property transferred in such a transfer shall be treated as if it were included in the gross estate of the deemed transferor at the value of such property taken into account for purposes of the tax imposed by section 2601; and

cannot be allowed to pass to the trustees of Mr. Smith's revocable trust. The trust, however, should contain a provision allocating such income to the family trust, rather than to the marital deduction trust in order to ensure that the section 691(c) deduction will be available against this income when received.

d. *Closely Held Stock.* Although the 1976 amendment to section 303 of the Code allows capital gain treatment for the redemption of certain closely held stock in order to pay the generation-skipping tax, the amount of such stock held in Mr. Smith's estate which eventually will be held in the trust will not meet the qualifying tests of section 303, because the percentage of Mr. Smith's gross estate represented by this stock is too small.[114] Accordingly, it will make no difference whether the stock passes to the trust or is directly disposed of under the will. The stock should be allowed to pass with the residuary estate.

2. Revocable Trust

Mr. Smith should be advised to fund his trust now by transferring his marketable securities to the trustees. This will ensure proper management and preservation of these assets in his declining years, and will reduce the cost of administering his probate estate by reducing the base on which the executors' and attorneys' fees are computed.

a. *Legacies.* There is no reason not to carry out Mr. Smith's desires to change the legacies from his revocable trust to eliminate that to his son, Peter, and to add legacies for his granddaughter, Elizabeth, and his great-grandchildren, and to increase the legacy to Yale. Even if he were to lose the transition rule protection for the trust by decreasing the total amount of the legacies, he has determined that he wishes to update his estate plan.

b. *Marital Deduction Trust.* Under the marital deduction transition rules,[115] the maximum allowable marital deduction under Mr. Smith's present trust would be 50% of the value of Mr. Smith's adjusted gross estate if his death occurs before January 1, 1979. Since his adjusted gross estate will be in excess of $500,000, the 1976 Act's increased limitation of the first $250,000 of marital deduction property[116] is irrelevant and there is no need to amend the trust to take advantage of the new provisions. However, if Mr. Smith does not change the language in his marital deduction formula to exclude from the computation of the maximum allowable marital deduction the amounts of generation-skipping transfers with respect to

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(C) under regulations prescribed by the secretary, any item of gross income subject to the tax imposed under section 2601 shall be treated as income described in subsection (a) if such item is not properly includible in the gross income of the trust on or before the date of the generation-skipping transfer (within the meaning of section 2611(a)) and if such transfer occurs at or after the death of the deemed transferor (as so defined).

[114] I.R.C. § 303(b)(2)(A) requires that, for the provisions of § 303(a) to apply, the value of all the closely held stock must exceed 50% of the adjusted gross estate; in the example, Mr. Smith's stock comprises only 5% of his gross estate and, assuming "normal" debts and expenses of 5%, only 5.3% of his adjusted gross estate.

[115] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(d)(1), 90 Stat. 1520.

[116] *See* I.R.C. § 2056(c)(1)(A).

which he is the deemed transferor, the trust property held in the 1965 trust will be added to his adjusted gross estate for purposes of determining the total marital deduction to the extent the transition rule protection of the 1965 trust is lost.[117] The recommended exercise of his power of appointment over that trust would not result in the loss of protection. Nevertheless, in case Mr. Smith should ever change his mind about the disposition of the 1965 trust property, as he would if John, V should predecease him, it would be wise to change his marital deduction formula to exclude all generation-skipping transfers from consideration as marital deduction property. Failure to do so could result in the overqualification of the trust for marital deduction purposes.[118]

c. *Family Trust.* Even though Mr. Smith's son, Peter, has a short life expectancy, his premature death during the term of the family trust will not incur a generation-skipping tax because of the postponement provisions, so he should still be included as a discretionary beneficiary. Since substantial medical expenses may be incurred because of Peter's illness, the continued flexibility obtained by having him as a beneficiary is desirable. Thus, no change should be made to the provisions of this trust, except perhaps to add the requirement that, if Mrs. Smith disclaims any portion of the marital deduction trust, the property disclaimed should be held in a separate spray trust for the Smiths' issue, roughly identical to the family trust. Disclaimed marital deduction property should not be allowed to pass into the family trust as would occur under the current estate plan, since the disclaimer almost certainly would be ineffective.[119]

d. *Trusts for Children.* As Mr. Smith desires, the provision establishing trusts for each of his children should be amended to give each child a limited testamentary power to appoint the trust property to or among such one or more of Mr. Smith's issue and their spouses, including the child's spouse, but not including the child or his estate or his or her estate's creditors. Although this amendment will result in the loss of transition rule protection, it also will result in greater flexibility upon the death of each child by enabling the children to fragment the tax effects of the generation-skipping law if it should prove necessary or advisable to do so. In the funding clause of the separate trusts for Mr. Smith's children, the trustees should be directed to treat the gift of the farm as a part of John, Jr.'s share in order to equalize the benefits among the children and their respective issue.

It should be remembered that the various powers of appointment given to Mrs. Smith and the three children can be exercised in their wills so as to postpone or even eliminate the imposition of the generation-skipping tax by bringing to bear postponement rules or eliminating generation-skipping aspects of the trust. However, if Mr. Smith were willing to forego

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[117] *See* I.R.C. § 2602(c)(5)(A).

[118] See S. Surrey, W. Warren, P. McDaniel & H. Gutman, Federal Wealth Transfer Taxation 810-15 (1977) for a discussion of the overqualification problem.

[119] I.R.C. § 2518(b)(4) requires that, for a qualified gift tax free disclaimer, the interest disclaimed must pass to a person other than the disclaimant. However, the Technical Amendments Bill, H.R. 6715, 95th Cong., 1st Sess. (1977), would make such a parallel trust unnecessary, since a disclaimer causing the disclaimed property to fall into the trust for the disclaimant's benefit would nevertheless be qualified. For a discussion of disclaimers see in this issue Schwartz, *Effective Use of Disclaimers*, p. 551 *infra*.

some flexibility and to limit the benefits to each child, he could provide that a maximum of $250,000 is to be transferred to each child's trust, and that the balance of the trust property be used to fund separate trusts for his grandchildren and great-grandchildren on terms similar to the irrevocable trust to be created for Elizabeth. To achieve maximum flexibility, however, Mr. Smith should be advised to fund the children's trusts with the full amount of the trust property remaining at the time they are created. Any amounts to pass to or for the benefit of a grandchild must do so in a manner that will make such property includible in the grandchild's estate even if the grandchild should die prior to reaching age twenty-five, at which time any continuing trust will terminate. A general power of appointment granted to the beneficiary of any continuing trust would be sufficient to achieve this purpose.

e. *Trustees.* In none of the potential successive death situations outlined above does the appointment of an individual trustee cause the imposition of a generation-skipping tax earlier than it otherwise would have been imposed had a bank been the trustee. In no case would a trustee in a generation younger than Mr. Smith have a present power, other than the power to distribute income or principal to Mr. Smith's lineal descendants assigned to a generation younger than the trustee's own,[120] that would terminate at a time when there are no other younger generation beneficiaries assigned to his own generation. In fact, it is even possible that use of an individual trustee can postpone the generation-skipping tax, as where such a trustee is the only living beneficiary possessing a present power. Accordingly, Mr. Smith's trustee designation can be amended as he wishes without adverse consequences under the statute.

3. Irrevocable Trust for Granddaughter

The irrevocable trust to be created for Mr. Smith's granddaughter, Elizabeth, should be drafted to give the trustees discretion to distribute income and principal to Elizabeth and her issue, and precatory language should be included reflecting Mr. Smith's desire that the distributions be used for educational purposes. To the extent so used, in jurisdictions where educational expenses are not considered to be within a parent's obligation of support of a minor child,[121] the income of the trust would be taxable directly to Elizabeth and not her father. For additional flexibility, particularly on Elizabeth's death, it would be wise to include a limited power of appointment for her so that, if necessary or advisable at that time, she could shift the generation-skipping tax burden to her husband's estate by appointing the property to him outright or giving him a general power, or

[120] The power in an individual trustee to distribute income or principal only among the grantor's lineal descendants in a generation lower than the trustee's is not considered to be a present power. I.R.C. § 2613(e).

[121] It is generally assumed in Massachusetts, for example, that education is not within a parent's obligation of support. While there is no specific statutory or common law authority for this proposition, it is a rule which has developed in practice due, at least in part, to the requirement that a child be in school only through age sixteen and the availability of public education at no cost to the parent through the high school level.

postpone the imposition of the tax by creating a present interest in her husband. Of course, a gift tax return will have to be filed when the trust is funded.[122]

4. Gift Program

In order to continue passing as much as possible of his estate to the lower generations, Mr. Smith should be advised to continue his program of making annual $6,000 gifts. No gift tax or generation-skipping tax will be incurred as each gift is made, and under the revised provisions of section 2035 no part of any such gift will be included in his taxable estate, even for gifts made within three years before his death.[123]

D. *Determination of the Tax*

At the time of each generation-skipping transfer, including those taking effect at the end of a suspension period, the generation-skipping tax will be determined by adding the property transferred to the gross estate, adjusted taxable gifts, and any other generation-skipping transfers of each deemed transferor, and then computing the tax on the basis of the deemed transferor's marginal transfer tax rate.[124] In the case of John, Jr., for example, on his death he would be the deemed transferor of property passing to his issue from the separate trust created for his benefit under the 1974 trust amendment. This property, reduced by any amount of the grandchild exclusion not previously used,[125] would have to be added to his adjusted gross estate, together with adjusted taxable gifts made by him during his lifetime and any other generation-skipping transfers of which he is the deemed transferor.[126] The tax on all but the generation-skipping transfer would then be subtracted from the tax figured on the total, and the balance would be payable from the trust property as the generation-skipping tax.[127] With respect to the property passing to John, Jr.'s children and Susan's children from Peter's trust, John, Jr. and Susan would be the

[122] The gift tax will be computed by calculating a tentative tax, using the new unified rate schedule, on all taxable gifts made during Mr. Smith's lifetime ($250,000) and subtracting a tentative tax on the 1978 gift ($50,000). The difference would be reduced by the credit available for 1978 ($34,000), and the balance would be payable when the return is filed for the calendar quarter in which the gift is made. The tax could be reduced somewhat by giving Elizabeth the power (a so-called "Crummey power") to withdraw $3,000 per year which would allow Mr. Smith to reduce the amount of the taxable gift by claiming the annual exclusion. *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), holding that the power is effective for purposes of the present interest exclusion, even though held by a minor who is incompetent to exercise it.

[123] I.R.C. § 2035(b)(2) provides an exception from the § 2035 "contemplation of death rule" for "any gift excludable in computing taxable gifts by reason of § 2503(b) (relating to the $3,000 annual exclusion for purposes of the gift tax) determined without regard to § 2513(a)" (the gift splitting provisions). For a discussion of amended § 2035 see in this issue, Note, *Section 2035: Taxing of Gifts Made Within Three Years of Death*, p. 577 *infra*.

[124] *See* I.R.C. § 2602.

[125] If the $250,000 grandchild exclusion were exhausted before the death of the last older generation beneficiary by virtue of distributions of corpus, then no portion of that exclusion would be available upon the subsequent termination event.

[126] *See* I.R.C. § 2602.

[127] *Id.*

deemed transferors,[128] and that property would be taxed accordingly.[129]

The generation-skipping tax on a taxable distribution is payable at the time the distribution is made. The rate of tax applicable to each distribution will depend, as with the case of taxable terminations, upon the amount of adjusted taxable gifts, other generation-skipping transfers and, in the case of a deceased deemed transferor, the value of the adjusted gross estate. Such tax is computed in the same manner as a tax on a taxable termination.[130] In the case of a taxable distribution, a generation-skipping tax return must be filed by the transferee,[131] whereas the trustee of the trust from which the transfer was made will file the return and pay the tax in the case of a taxable termination.[132]

Certain deductions and credits are available in determining the amount of the generation-skipping tax, including the charitable deduction,[133] the deduction for certain expenses paid by the trust,[134] the unused portion of the deemed transferor's unified tax credit,[135] the credit for property previously taxed and the credit for state death taxes.[136] The marital deduction is not available with respect to the computation of the generation-skipping tax, but generation-skipping transfers can be used in the computation of a deemed transferor's marital deduction for federal estate tax purposes.[137] The details of these deductions and credits are, however, beyond the scope of this article and an in-depth discussion of them should, in any event, await the dissemination of regulations.[138]

CONCLUSION

The generation-skipping tax provisions of chapter 13 and the regulations to be published should be studied with great care. Although this new tax creates additional burdens for estate planners and, without proper planning, new taxes for many clients, the imposition of the tax can be postponed through successive generations almost as effectively as the estate tax. In many cases, it can be avoided altogether. Outright transfers, instructions to trustees which require that beneficiaries be paid trust income rather than trust corpus, the $250,000 grandchild exclusion, and the transition rules are all devices which the estate planner can use to avoid the generation-skipping tax. There undoubtedly will be cases in which the pro-

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[128] *See* I.R.C. § 2612(a)(1).

[129] For the method of computation of generation-skipping tax on multiple transfers, see I.R.C. § 2612(b).

[130] *See* I.R.C. § 2602(a).

[131] I.R.C. § 2603(a)(1)(B).

[132] I.R.C. § 2603(a)(1)(A).

[133] I.R.C. § 2602(c)(2).

[134] I.R.C. § 2602(c)(5)(B).

[135] I.R.C. § 2602(c)(3).

[136] I.R.C. § 2602(c)(5)(C).

[137] I.R.C. § 2602(c)(5)(A).

[138] It should be noted that §§ 2603(d)-(e) provide special rules regarding the alternative valuation date and for generation-skipping transfers within three years of death of the deemed transferor.

tection of the transition rules has been inadvertently and irretrievably lost,[139] but for the vast majority of estate planning clients the opportunities to minimize, or even eliminate the generation-skipping tax, represent only the tip of the estate planner's iceberg.

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[139] For example, a trust created or amended on May 15, 1976 by a grantor who died on July 1, 1976 would not be protected. If his son was a younger generation beneficiary with a present interest in the trust and died on August 15, 1976, his death would have caused a taxable termination, the return for which would have had to have been filed on May 15, 1977. Query, what did the trustee use for a return?